

A Draftsman's Wishes That He Could Do Things Over Again - U.C.C. Article 9

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It has been said that for one's peace of mind one should never know how two things are made: sausages and legislation.¹ I don't know about the sausages, but I can testify to the occasional usefulness of that principle as to legislation. Nevertheless, I intend to take the reader behind the prelegislative scene, in two situations upon which I look back in connection with my service in 1967-1971 as Associate Reporter for the Review Committee on Article 9, appointed by the Permanent Editorial Board for the Uniform Commercial Code ("the Code"). As matters worked out, in connection with this appointment, I became the primary draftsman of the 1972 Revision of Article 9 of the Code.²

I do not intend the above comment on the curiosities of the legislative process to be applied too broadly. I know from personal participation that the committees which drafted the several portions of the Code originally and various minor interim amendments and the Review Committee of 1967-71 functioned ably and conscientiously, as did all their advisors. Indeed, I take the position that many fields of

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1. Another version of "that old saw: Those with weak stomachs should not watch the making of sausages of laws." Shepard, *Morton Downey, Jr., Takes Tube to Speaker's Corner*, Wall St. J., July 21, 1988, at 12, col. 3.

2. This amendment was adopted in California effective 1975. Various changes were made in California which do not affect the subject-matter of this article. The Code in California is known as the California Commercial Code; Article 9 is called Division 9; and the citation style, instead of being, e.g., "§ 9-103" is "§ 9103."

law are now so complicated that neither legislative committees composed of nonlawyers nor lawyers of ordinary backgrounds nor courts with nonspecialized subject matter jurisdiction can develop complicated fields of law adequately. The only way that the legal problems of complicated situations can be addressed and revised when necessary (other than through administrative agencies) is through the medium of select committees of organizations like the National Conference of Commissioners on Uniform State Laws, The American Law Institute, The American Bar Association, or state or city bar associations.³ This has been, of course, the method by which the Code was drafted and kept up to date and by which modern corporation laws and the like have been kept up to date. Nevertheless, the "old saw" associating legislative drafting with making sausages may fit some curiosities in the Article 9 revision process which I shall mention.

In the revision of Article 9 we were faced, in the first situation to be discussed, with an urgent time pressure to cure a mistake belatedly discovered, and in the second situation with a standing injunction from the strategic masterminds for the Code not to disturb provisions that were not causing trouble.⁴

I. TRYING TO IMPROVE THE RULES FOR THE SELECTION OF THE GOVERNING STATE LAW IN THE EVENT OF INTERSTATE REMOVAL OF GOODS

The Code has a general conflict of laws section in section 1-105 and originally had a superseding specialized set of provisions for Article 9 in section 9-102 and section 9-103. These were generally unsatisfactory, and there were uncertain overlaps in subsections (3) and (4) of section 9-103. Those provisions are still in effect in the states which have not adopted the 1972 amendments, but since my subject is the process of the 1972 amendments, I leave criticism of the old sections to Professor Weintraub's discussions.⁵

We eliminated any language in section 9-102 which affected the conflict of laws; achieved a clarification by limiting the application of section 9-103 to questions of perfection as distinguished from questions of validity; and then tried to restate section 9-103 understandably and correctly. Fortunately, while we were still patching the old

3. Kripke, *Mr. Levenberg's Criticism of the Final Report of the Article 9 Review Committee: A Reply*, 56 MINN. L. REV. 805, 806-08 (1972); Kripke, *A Reflective Pause Between U.C.C. Past and U.C.C. Future*, 43 OHIO ST. L.J. 603, 604-05 (1982).

4. The force of this injunction was brought home to me by the storm which broke over my head from on high when the agenda submitted as my first communication to the Review Committee was based on my then recent article, *Suggestions for Clarifying Article 9: Intangibles, Proceeds and Priorities*, 41 N.Y.U. L. REV. 687 (1966).

5. See R. WEINTRAUB, COMMENTARY ON THE CONFLICT OF LAWS § 8.40 (2d ed. 1980); R. WEINTRAUB, COMMENTARY ON THE CONFLICT OF LAWS 352-62 (1971). All references in later footnotes to this work are to the second edition.

structure of section 9-103 (and in hindsight not doing a very good job), Harold F. Birnbaum, Esq., wrote us a trenchant criticism of our draft and suggested breaking it down into five different subject matters to be treated in five different subsections. In general, we followed his useful structure, with some changes in detail. But on the crucial conflict of laws question about to be discussed, Mr. Birnbaum acquiesced in our formulation. As the matter came closer to the time for final adoption of the revised Article 9, the applicable conflict of laws provision for ordinary goods still read as follows: "[p]erfection or nonperfection is governed by the law (including the conflict of laws rules) of the jurisdiction where the collateral is when a conflicting claim arises."⁶ Except for the last five words this was close to standard theory at the time.⁷ These words had been added in an attempt to fix the time to determine where the collateral is. This question has been left undetermined by standard theory at the time, which made the governing law the jurisdiction where the transaction occurred.⁸ But "the transaction" is composed of many events, as the discussion below shows.

No one had questioned our formulation. But late in the day, a crisis arose with respect to our formulation. A student of Professor Vern Countryman at Harvard Law School pointed out in the Spring of 1971 that no one could tell in advance where the collateral might be when a conflicting claim might arise, and therefore one could not know in advance (when transactions were being formulated and documented) what the applicable law would be. (The nationwide adoption of Article 9 diminished the importance of state-to-state variations in rules, but was then still a long way into the future.) I flew from New York to Boston to consult with Professor Robert Braucher of Harvard Law School (the Reporter), Professor Countryman, and

6. This language appeared publicly in Preliminary Draft No. 2 (1970), published in 25 BUS. LAW. 1067, 1112 (April 1970). This language appeared as late as the Review Committee's Report to the Permanent Editorial Board, January 7, 1971, and in the Final Report of the Review Committee, as amended and approved by the Permanent Editorial Board, dated February 24, 1971, and submitted to the Council of the American Law Institute at its meeting of March 10-13, 1971. Both of these appear in sets of my working papers which I have donated to the law libraries of the Law Schools of the University of San Diego and New York University.

7. R. WEINTRAUB, *supra* note 5, § 8.28; H. GOODRICH & E. SCOLES, HANDBOOK OF THE CONFLICT OF LAWS § 153 (4th ed. 1964).

8. E. SCOLES & R. WEINTRAUB, CASES AND MATERIALS ON CONFLICT OF LAWS 612 n.2 (2d ed. 1972): "The almost universally recognized common law rule was that the interest that a person acquires in personal property is determined by the law of the situs of the property at the time of the transaction on which that person bases his claim." *Id.* See also R. Weintraub, *supra* note 5, § 833.

Peter F. Coogan, Esq., who was a leading authority on the Code and a Consultant to the Review Committee.

In a superficial sense we could have concluded that the student's criticism was not sound. Any court administers the law of the jurisdiction where the court sits, which will ordinarily be the jurisdiction where the conflict arises. But that law includes its conflict of law rules, and these take the governing law back to a jurisdiction which has some relevance to the events in question. In a real sense the student was right: our formulation had been meaningless, for it failed to define the jurisdiction whose law would be applied. So something had to be done.

We had to do it in haste. Any change to be made had to be adopted in that Spring of 1971 by the membership of the American Law Institute and that summer by the National Conference of Commissioners on Uniform State Laws. Otherwise, the final adoption of the revised Article 9 would be set back a whole year. We knew that not only the Reporters but the members of the Committee were exhausted after four years of hard work, and the money to fund travel expenses of Reporters and Committee was running out.

Out of such considerations is legislation made!

We therefore hurriedly adopted a proposal (which was not my suggestion) which became the "last event test" embodied in section 9-103(1)(b).⁹ By quick work, consent of all necessary bodies was obtained, and the amendments were approved by the two organizations on schedule.

Subsequently, this formulation has been criticized by leading authorities who command respect. When I was in England working on a draft of a book, I began getting frantic phone calls that Peter Coogan had criticized and raised questions about the "last event test" (at whose birth he had been present) in an article in the *Harvard Law Review*.¹⁰ Professor Ray David Henson, a member of the Review Committee, had also proposed interpretations that raised questions.¹¹ When I came back to New York, I dealt with these questions and with what I thought were misinterpretations of the "last event test," in a law review article.¹² I still think that my article was right, and that it correctly answered the challenges that had been raised; thus I do not have a confession of error to make.

Nor am I bothered by a more recent trenchant criticism of the

9. "[B]y the law of the jurisdiction where the collateral is when the last event occurs on which is based the assertion that the security interest is perfected or unperfected." U.C.C. § 9-103(1)(b) (1972).

10. Coogan, *The New UCC Article 9*, 86 HARV. L. REV. 477, 532-44 (1973).

11. R. HENSON, *HANDBOOK ON SECURED TRANSACTIONS UNDER THE Uniform Commercial Code* 220 (1973).

12. Kripke, *The "Last Event" Test for Perfection of Security Interests Under Article 9 of the Uniform Commercial Code*, 50 N.Y.U. L. REV. 47 (1975).

"last event test" by Professor Weintraub who finds "bizarre possibilities" in my interpretation that the last event for particular collateral may be the arrival of that collateral in a state where there is an appropriate filing. He there puts a case in which, in an interstate situation, different parties perfect by filing in different states, but A, who filed first in State X, moves his collateral to State Y, where B was first to file. Professor Weintraub suggests further drafting to cover situations of this kind.¹³

But when we reworked section 9-103, we already knew that there were several nightmares like this lurking in the bushes for statutory draftsmen, more than Professor Weintraub has found. The two security interests might be against different owners-debtors, and then the collateral might come into a single ownership, by sale or merger.¹⁴ My article in 1975 and Professor Weintraub's second edition in 1980 both discuss a two jurisdiction case in which: (1) X perfected a security interest in collateral in California; (2) X lost perfection by failure to reperfect after the collateral had been moved to Oregon for over four months, where Y perfected a security interest in it; and (3) X claimed revival of his perfected status with its early perfection date on return of the collateral to California, with priority over Y's reperfecting in California.¹⁵ There are other "conundrums" of this kind which make clear that it is not feasible to draft with the precision necessary to provide express answers to every case when complicated facts involving more than one state or more than one debtor later collapse into a simpler structure, but create more complicated priority problems. I believe that it is necessary to leave these cases to the good sense of the courts.¹⁶

As stated, prior to the Code a typical formulation was that "the interest that a person acquires in personal property is determined by the law of the situs of the property at the time of the transaction on which that person bases his claim."¹⁷

Viewing the history of this issue with the benefit of hindsight, it is amazing that the experts on the conflict of laws should have been

13. R. WEINTRAUB, *supra* note 5, § 8.41.

14. For a recent case, see *Bank of the West v. Commercial Credit Financial Servs., Inc.* 852 F.2d 1162 (9th Cir. 1988).

15. *In re Miller*, 14 UCC Rep. Serv. 1042 (Bankr. J., D. Ore., 1974); see Kripke, *supra* note 12, at 49-50, 57-60; R. WEINTRAUB, *supra* note 5, at 487, n.37.

16. A recent case with good common sense is *First Nat'l Bank in Brookings v. John Deere Co.*, 409 N.W. 2d 664 (S.D. 1987). The reasoning does not fit any established customary statements of the conflict of laws rule or of the substantive rule involved.

17. See notes 7 and 8.

satisfied with the ambiguity of the words "the situs of the property at the time of the transaction." Professor Weintraub now teaches us that there are normally five steps in the perfection of a security interest even in a single state.¹⁸ Which one of these was the transaction? Professor Weintraub says it is the last step to occur.¹⁹ The sudden change decided upon at Harvard in favor of the "last event" was superior to an unexpressed "last step" standard, and was an attempt to narrow the ambiguity by focusing on the "last step," which we called "the last event." Our formulation also covers a case where the assertion is "that the security interest is . . . unperfected." The steps in the transaction may all have occurred in State A, leading to perfection, but our formula also covers the absence of a step, such as the omission of a necessary filing (or a filing in the wrong place, which is the same thing) or the omission of filing of a continuation statement after the property moved to State B, where problems of reperfecting or lapse were added. Our formulation was superior to all of those that refer merely to "the transaction."

Thus, I still am satisfied that the "last event test" was and is sound "if read cheerfully" (to use a phrase of Grant Gilmore) and that the criticisms of the experts are not sound.

Then why do I write that I wish I could do things over again? The answer is that my students do not seem to understand the test any better than the experts. Even the students have difficulty with it. And thus, I found myself having to tell the students: "Don't worry about the test. All you have to do is use common sense and it will get you to the right answer."

But if that is the ultimate standard, can we not write a common sense standard into the conflict of laws provision of Article 9? Everyone will tell me that such a standard will never do, so I have an alternative. Let us adopt the formulation in this area of the *Restatement (Second) of Conflicts of Laws* section 6(2), which says that when there is no statute determining what law the forum will apply, "the court will take account of the facts as listed in this subsection in determining the state whose local law will be applied to determine the issue at hand."²⁰ The factors include so many broad items with

18. R. WEINTRAUB, *supra* note 5, § 8.41.

19. *Id.*

20. RESTATEMENT (SECOND) OF CONFLICTS § 6. Choice-of-Law Principles

(1) [quoted in text]

(2) When there is no such directive, the factors relevant to the choice of the applicable rule of law include

(a) the needs of the interstate and international systems,

(b) the relevant policies of the forum,

(c) the relevant policies of other interested states and the relative interests of those states in the determination of the particular issue,

(d) the protection of justified expectations.

(e) the basic policies underlying the particular field of law,

no indications of their relative weights or importance that a court will have to use its common sense to determine what law should govern, but everyone will be happy with the wisdom of the framers of the Restatement.

If this approach be deemed too frivolous, then we should go back and make clear that the term "last event" includes nonhappenings such as the lapse of a filing or the failure to file in a removal jurisdiction, and it also includes the arrival of the collateral in a jurisdiction where there already is an appropriate filing.²¹

II. SECTION 9-306(5) - WHAT IS IT AND WHY IS IT?

Section 9-306(5), set forth in the footnote,²² appeared in the 1952 version of the Code in three lettered clauses, referring to the return of *collateral* rather than the return of goods.²³ The term "returned" did not expressly contemplate repossession. Nevertheless, an official

(f) certainty, predictability and uniformity of result, and

(g) ease in the determination and application of the law to be applied.

21. A splendid recent article on this subject is Harrell, *The Modern World of Conflicts for Article Nine Security Interests, Part I: Multistate Choice of Law Analysis and the Impact of the 1972 Revisions*, 42 QUARTERLY REP. 156 (1988).

22. U.C.C. § 9-306 (1978). "Proceeds"; Secured Party's Rights on Disposition of Collateral:

(5) If a sale of goods results in an account or chattel paper which is transferred by the seller to a secured party, and if the goods are returned to or are repossessed by the seller or the secured party, the following rules determine priorities:

(a) If the goods were collateral at the time of sale, for an indebtedness of the seller which is still unpaid, the original security interest attaches again to the goods and continues as a perfected security interest if it was perfected at the time when the goods were sold. If the security interest was originally perfected by a filing which is still effective, nothing further is required to continue the perfected status; in any other case, the secured party must take possession of the returned or repossessed goods or must file.

(b) An unpaid transferee of the chattel paper has a security interest in the goods against the transferor. Such security interest is prior to a security interest asserted under paragraph (a) to the extent that the transferee of the chattel paper was entitled to priority under Section 9-308.

(c) An unpaid transferee of the account has a security interest in the goods against the transferor. Such security interest is subordinate to a security interest asserted under paragraph (a).

(d) A security interest of an unpaid transferee asserted under paragraph (b) or (c) must be perfected for protection against creditors of the transferor and purchasers of the returned or repossessed goods.

23. In this historical comment, I have followed Skilton & Dunham, *Security Interests in Returned and Repossessed Goods under Article 9 of the Uniform Commercial Code*, 17 WILLAMETTE L. REV. 779, 799-803 (1981) [hereinafter Skilton]. This article in full is must reading for anyone interested in this topic.

comment to the section²⁴ in effect "amended" the statute and lumped repossessions with returns. This dubious method of expansion in Code history frequently signals an afterthought. Because of the word "collateral" this provision should not have affected a credit sale involving the creation of an account (where there is no surviving relationship of the seller or other holder of the receivable with the goods), rather than chattel paper (where there is such a relationship).²⁵ However, the Comment also purported to bring accounts within the subsection by asserting that the assignee of accounts will generally be entitled to the returned goods by an analogy to the section. The Comment also indicated, without explanation, that in the accounts context the inventory financier would prevail, in contrast to the rule of the text which provided that the holder of the chattel paper would prevail as against the inventory financier.

In 1956, changes were proposed to meet criticisms of the 1952 Code by the New York Law Revision Commission. The changes proposed the addition of clause (c) of section 9-306(5), taking the principles applicable to accounts out of the Comment and putting them into the text. Also, explicit reference was to be made to repossessions as well as returns. These changes were made ultimately in the 1962 amendments to Article 9, but there is no history to my knowledge showing that the additional problems arising from the extensions to repossessions and to accounts were seriously studied.

Thus, the section was handled in slap-dash fashion both as originally conceived and as patched by Comments which went beyond the text. It was then face-lifted simply by putting material of the Comments into the text.

Possibly because the original section spoke so confusingly only about the return of goods rather than repossession, and because the Official Comments were written later, neither I nor others who had some experience in chattel financing (now known as asset-based financing) and who advised the original draftsmen focused on the section in the early days of the Code. Nor did I do so at the time of the 1956 recommendations and the 1962 amendments, even though the addition of the references to repossessions in the text should have alerted me to the fact that the section concerned problems very

24. U.C.C. § 9-306(5) comment 4 (1952).

25. To prevent confusion, I note the following distinction:

(1) A sale of goods on open credit, which "creates" an account, is not a security transaction. Goods may be held by the original vendee who owes an account, but they are not "collateral," for there is no security arrangement. If the vendee simply failed to pay and did nothing, the seller would not have a security interest or right in the goods (subject to qualifications not here relevant). But (2) the "transfer" of an account, even without recourse, to a financier technically creates a security interest under the Code's definitions, with the account, but not the goods, as collateral. See U.C.C. §§ 1-201(37); 9-102(1)(b); 9-105(1)(c) (1985).

much within my specialized practice and to which I might have contributed something. So, perhaps, *mea culpa*. One reason for my diffidence was that until I left that specialized practice and began full-time teaching in a law school, the draftsmen viewed me and others like me with some suspicion. This was manifested by an injunction of Professor Soia Mentschikoff, the Associate Reporter and wife of Karl Llewellyn, the Chief Reporter, to an early committee of the Association of the Bar of the City of New York concerned with the Code "not to let the finance companies capture the Committee" and indeed, I was kept off of that early New York City Committee.²⁶

Shortly after I left practice in 1966 and began teaching, I was pressed into service as one of the two Reporters for the Review Committee on Article 9, which functioned from 1967 to 1971 and led to the 1972 amendments of Article 9. As such I raised some questions about section 9-306(5). But we did not explore the questions because we were under instructions not to re-open sections which had not caused trouble. As so frequently happened, obedience to this instruction led to neglect of an opportunity to forestall future trouble, which later occurred as shown by Professor Barnes' extensive discussion of recent cases.²⁷ *Mea culpa* again: I should have pressed the point. But the whole complex of problems on intangibles, proceeds, and priorities then loomed very large,²⁸ as did the problem of fixtures, and the Committee devoted most of its attention to those matters.

My problems with the subsection are more fundamental than the litigated cases reveal. They can best be discussed in terms of a hypothetical case. As the Official Comments to the section still show, its chief application has been in the following repossession case, which will be the principal subject matter of my discussion.

A secured party has a security interest in the inventory of a dealer in automobiles.²⁹ The automobile dealer sells the goods to a buyer in

26. Kripke, *A Reflective Pause*, *supra* note 3; Kripke, *Reflections of a Drafter*, 43 OHIO ST. L.J. 577, 578 (1982).

27. Barnes, *Reaffirming the Dominance of Notice in Article 9: A Proposed Modification of Priorities in Returned and Repossessed Goods*, 48 U. PITT. L. REV. 353, 363-84 (1987) [hereinafter Barnes]. See also discussion of cases in Skilton, *supra* note 23. The Barnes article is must reading for any student of these problems, although — as will be seen below — I have substantial difficulties with it.

28. See *supra* note 4.

29. I use automobiles as an example, because the transaction is most likely to be in the reader's experience. While automobiles present added complications stemming from the certificate of title system, these added difficulties are not germane to my present limited purpose.

ordinary course of business (BIOC). This wipes out the interest of the inventory financier in the goods.³⁰ I shall call this financier SP1 (1st Secured Party). The dealer “assigns” (to use the statutory language) the resulting chattel paper to a different secured party — a chattel paper financier (SP2). The BIOC ultimately defaults and SP2 repossesses the goods.

I do not propose to try to solve all of the issues on these facts under the present statutory language.³¹ My purpose here is to raise questions, and sometimes to suggest answers, as to scope and policy of the statute, in the hope that when Article 9 is next re-opened, attention can be paid to this subsection. It should be eliminated or rewritten after a comprehensive review of the need for it and of the questions raised in this article. As an introduction to my series of discussions, I quote a caption in the Skilton and Dunham article: “The Rationale of section 9-306(5) - Does It Make Sense?” and the conclusion: “Happily, we put an end to our encounter with section 9-306(5). In fact, we probably would like to put an end to section 9-306(5). In our opinion, Article 9 would have been better if there had been no subsection (5). . . .”³²

1. Should there be a section 9-306(5)? Professors Skilton and Dunham contend that all of the conflicts between inventory secured parties and chattel paper or account secured parties are already settled by the main priorities sections of Article 9, namely, sections 9-312, 9-308 and 9-309, and the earlier subsections of section 9-306, particularly section 9-306(3).³³ They claim that section 9-306(5) would never have been necessary were it not for the fact that before the definition of “proceeds” (the subject matter of section 9-306) was broadened in 1972, there were some questions as to the scope of that term, and therefore, it had been unclear that returned goods would be considered proceeds of the chattel paper. Thereafter, as already pointed out, the additions of the clauses with respect to accounts and the inclusion of repossessions were afterthoughts, first noted by comment and then later added in 1962 without adequate thought to the problems. Finally, in 1972, when the definition of “proceeds” was broadened (primarily to make clear that insurance proceeds should be considered statutory proceeds), the effect of the broadened definition on the need for section 9-306(5) was not considered. I do not now suggest a firm answer to this question, because it is possible that at the next revision of Article 9 the cited priorities sections may be revised, and the need for section 9-306(5) could not

30. U.C.C. § 9-307(1) (1985).

31. The reader should see the excellent comprehensive discussion by Professors Skilton and Dunham. Skilton, *supra* note 23.

32. Skilton, *supra* note 23, at 798, 857.

33. *Id.* at 798-99.

be decided until those revisions were determined.

2. The Code assumes that SP1, the inventory financier, can regain his rights to the goods and create an issue of priority with SP2 "if the goods were collateral at the time of sale for an indebtedness of the seller which is still unpaid."³⁴ Can this really mean that when SP1 lost his inventory security interest on sale of the goods to BIOC, and, also, in effect, lost his proceeds claim to the chattel paper on sale thereof to SP2 under section 9-308, the Code resurrects his security interest for him even if he does not have any contractual right to it? On its face, the section is seemingly independent of the possibility that the inventory financing may have been a "one shot" deal in which the dealer did not have a "spreader" clause encumbering all inventory to secure all debt, with after-acquired property effects. Indeed, section 9-306(5) is so broad on its face that it could apply to a sale of goods by an owner of *equipment*, in which a single-deal lender lost his security interest by authorizing sale under section 9-306(2), a situation totally unlike an inventory situation with a continuing relationship. In my view, the Code should not give SP1 any resurrection of rights which he does not have by contract.

3. In the typical automobile inventory financing, even though all inventory may secure all debts under a "spreader clause," the dealer is obligated upon the sale of each unit to pay off the specific loan against that unit made by SP1. The dealer does so typically by selling the resulting chattel paper to SP1 and using the proceeds to pay off the inventory debt related to that unit; or, if the dealer has sold the chattel paper to SP2, by paying SP1 from the cash secured for the chattel paper. If the chattel paper held by a SP2 on a unit later defaults, and a repossession occurs (posing the problem dealt with by section 9-306(5) and this article), SP1 has not suffered a credit loss on that unit, because he has typically been paid off on the unit, and there is no need for the law to volunteer him a helping hand.

But the question arises whether, under the typical "spreader clause" SP1 is still a creditor "for an indebtedness of the seller which is still unpaid,"³⁵ even though the unit release price has been paid, and though the remaining indebtedness may be fully secured by the remaining units. In my opinion, the statute should not be read in this fashion, which vastly broadens its application. Indeed, if that reading were permitted, the "junior" security interest allowed to SP2 on returned goods under section 9-306(5)(c) relating to accounts

34. U.C.C. § 9-306(5)(a) (1985), quoted *supra* note 22.

35. *Id.*

could never be worth anything.

4. To what “repossessions” and “returns” should the present statute and any revised statute apply, and at what point in the process of terminating BIOC’s rights? After BIOC defaults and remedial action results in his giving up the goods, or the goods are taken from him, there can be a large variety of sequences of events.

We must first put aside the cases where the goods are returned to or repossessed by SP2, but never again reach the original dealer. SP2 can repossess and sell the goods himself, without going through any dealer; or he can repossess and temporarily store the goods with a different dealer and then ultimately sell them himself to or through the other dealer. The original dealer never sees them again. While the introduction to section 9-306(5) purports to apply its rules if the goods have been repossessed either by the original dealer or the secured party, I cannot take seriously the possible intimation that the rights of SP1 are resurrected if SP2 withholds the goods from the original dealer. Professor Barnes apparently thinks otherwise, as discussed below.³⁶ In my opinion section 9-306(5) has not become applicable.

Now assume that BIOC returns the goods to the original dealer, or that dealer repossesses the goods with or without SP2’s consent, or SP2 receives the goods by return or repossession, and delivers them to the original dealer. Has the Code become applicable — i.e., has SP1’s original security interest reattached to the goods, presenting a conflict with SP2’s rights? If so, how should the conflict be resolved? In my opinion SP1 cannot have a security interest in the goods by contract and cannot properly be given a security interest in them by section 9-306(5) unless and until ownership has reverted to the dealer and is neither still vested in BIOC nor vested in SP2.

But “ownership” may never reach the dealer. SP2 may leave the goods with the dealer only temporarily, for storage or repair. Or he may authorize the dealer to sell them to third parties for SP2’s account in an enforcement of the security interest under Part 5 of Article 9. Or SP2 may himself sell the goods to third parties from the dealer’s premises, either as a way of enforcing the security interest under Part 5, or in a case where SP2 has cleared ownership in himself before lodging the goods with the dealer. Only when SP2 sells the goods to the dealer, either after he has cleared ownership against BIOC, or in a sale under the security interest in the goods which clears title against BIOC, can the contest between SP1 and SP2 governed by section 9-306(5) arise. But section 9-306(5) with its loose terms of “return” and “repossession” seems to ignore these

36. See *infra* point 7, at 14.

distinctions.³⁷

When SP2 does sell the goods to the dealer, the sale may be a contract negotiated after the repossession or it may be pursuant to a contract based on an original "with recourse" assignment. Assume that the dealer has not yet complied with the contract by paying the price. Under some forms of the arrangement, ownership does not vest in the dealer until payment, and the point made in the preceding paragraph will apply. As stated, in my opinion the statute cannot govern priorities of conflicting claims by SP1 and SP2 against the dealer before the dealer owns the repossessed goods. If the dealer has acquired ownership, but has not yet paid SP2, the question arises whether SP2 is an "unpaid transferee of the chattel paper," when he may have released BIOC from liability and is relying on the obligation of the dealer. I think that the answer should be in the affirmative. I would urge that when this confusing statute is set straight the liability of the dealer to SP2 as an unpaid transferee should be considered to outrank any rights of SP1.

5. After a debtor on an account or chattel paper (BIOC) has been notified of the assignment thereof to SP2 (as is customary in the case of most chattel paper involving sizable goods), can a return of goods — implying a rescission of the contract — be made by agreement of BIOC with the dealer, when the assignee has not agreed to the rescission? Section 9-318(2) sanctions certain modifications of a contract by an account debtor and the assignor notwithstanding notice of the assignment. However, it seems clear from the implications of the first sentence of section 9-318(3) that where the receivable has been assigned, the dealer and account debtor cannot terminate the obligation to pay by "return" or "repossession" without the consent or acquiescence of the assignee (in the absence of facts giving the debtor the right to revoke acceptance of goods under sections 2-607 and 2-608). Should section 9-306(5) be invoked in the nonconsent case as giving SP1 a renewed interest in goods? There is no history or other indications showing that the draftsmen of the statute even considered this kind of question. In my opinion, the answer should be clearly negative.

6. Another issue is whether the question of the need for filing by

37. I note in passing that there may be rights in creditors of the dealer (including SP1) when SP2's leaving of the goods with the dealer is a consignment under § 2-326, unless SP2 has filed as required by §§ 2-326 and 9-408. There may be rights in new BIOC's if the relationship of SP2 and the dealer as to returned or repossessed goods amount to an entrustment under § 2-403(2) and (3). But neither of these rights is related to § 9-306(5).

SP2 after return or repossession (discussed below) and the resulting question of priorities can be avoided by SP2 making a filing to cover all repossessions and returns as soon as he begins his program of financing with the dealer, which may indeed occur before SP1 comes on the scene. One court has held that it can,³⁸ and this result may succeed in reversing the priority which would otherwise go to SP1 even on an account, where SP2 would otherwise be subordinate under clause (c) of section 9-306(5). Indeed, it seems likely that professional financiers of chattel paper and accounts have learned from the case cited, and have changed their practice. They now routinely file in advance to claim a security interest in returns and repossessions, so a serious question is presented whether section 9-306(5) continues to have whatever usefulness it may sometime have had.

7. A challenge to the priority rule of section 9-306(5)(b) as to chattel paper comes from Professor Richard Barnes.³⁹ Professor Barnes' article raises sharply the question what is meant by the word "transferred" in clause (a) of section 9-306(5). He draws a distinction between "full assignment" and "simple transfer." By the former term, he seems to mean a sale without recourse. By the latter term, he seems to mean any sale of the obligation with recourse, and any case where the loan or advance is less than the full value of the chattel paper. It is unclear whether by "full value" he means "the full face amount of the paper" (which may include finance charges in lieu of interest) or the "unpaid cash balance" (i.e., the unpaid cash balance of the dealer's sale transaction to BIOC, after deducting any down payment, and excluding interest or finance charges).

Professor Barnes invited my comments in 1985 on a very preliminary draft of his article. I wrote some criticisms, and the final article bears little resemblance to the draft, except that he rested strongly then and again in his published paper on an assumed sharp distinction between recourse and non-recourse assignments. If I understand him, he thinks that in a recourse assignment, "a simple transfer," the dealer still retains an interest in the chattel paper and the goods, and SP1 therefore, still has an interest in the goods. I tried to explain to him, obviously unsuccessfully, that there are numerous shades of recourse. The dealer's permanent commitment to SP2 may be either "full recourse" liability to repurchase the chattel paper on BIOC's default, or to repurchase the goods for the unpaid balance owing to SP2. But it may be limited, e.g., to repurchase the goods only if SP2 accomplishes repossession and returns the goods in good condition and within a specified period after BIOC's default, or

38. *Citizens and S. Factors, Inc. v. Small Business Admin.*, 375 So.2d 251 (Ala. 1979).

39. Barnes, *supra* note 27, at 487-403.

under various special arrangements as to the dealer's repurchase liability — limiting it, e.g., to a percentage of the face amount of all chattel paper sold to SP2 or a percentage of the amount of interest or finance charges involved in all chattel paper sold to SP2.

I think that a distinction between recourse and nonrecourse misses the point, for the purpose of our discussion. I studied the question of the classifications of types of contract for the transfer of receivables in an article some years ago and have returned to it on other occasions.⁴⁰ While the article is somewhat dated, it is still true under the prevailing judicial view that agreements under which *accounts* are sold "with recourse" in substance constitute loans and are therefore subject to usury restrictions, etcetera.⁴¹ On the other hand, while sales of *chattel paper* may superficially resemble the accounts transactions, the terms are typically such that even when the chattel paper is sold with recourse, the transactions are generally, for various purposes, held to be sales and not loans. For this reason, it is usually taken for granted that on a sale of chattel paper to SP2, even with recourse, the dealer has lost all interest in the chattel paper and the goods, and it follows that SP1 has lost all interest in the goods.

Therefore, in my opinion, the really relevant distinction is between (1) sales of chattel paper to SP2 for approximately the full unpaid cash balance of the transaction (i.e., net of finance charges), which transfer all of the interest of the dealer in the paper and the underlying goods, and (2) transactions in which SP2's payment to the dealer is significantly less than the unpaid cash balance, leaving the dealer with a residual right in the paper and therefore with a residual right in the goods through the paper. Whether SP1's overall inventory security interest would cover this latter residual interest of the dealer in the goods would depend on the form of inventory contract. It would be unlikely that any inventory lender would be relying on any such residual rights.

When the dealer has not retained any residual interest in the payments under the contract, it is not useful to contend, as Professor Barnes does, that SP1 retains a continued proceeds interest in the chattel paper. It is true that section 9-308(b) says that SP2 as a purchaser of chattel paper who gives value and takes possession has

40. Kripke, *Conceptual Obsolescence in Law and Accounting — Finance Relations Between Retailers and Assignee of Retail Receivables*, 1 B.C. IND. AND COMM. L. REV. 55 (1959); Kripke, *Book Review*, 46 N.Y.U. L. REV. 1220, 1224-25 (1971); Kripke, *Law and Economics: Measuring the Economic Efficiency of Commercial Law in a Vacuum of Fact*, 133 U. PA. L. REV. 929, 976-77 (1985).

41. Kripke, *Conceptual Obsolescence*, *supra* note 40, at 60-61.

“priority” over SP1’s interest claimed merely as proceeds, and that the word “priority” suggests that SP1 still has a junior interest in the paper. But since SP2 has advanced a sufficient sum so that he is entitled to get all of the collections on the chattel paper, it is not meaningful in a practical sense to treat SP1’s defined junior interest as amounting to anything real which would also give him a derivative security claim to the goods while in the hands of the BIOC. In particular, it does not serve to justify SP1’s statutory right to the goods on “return” or “repossession” to the dealer unless SP1’s contract gives him that right.⁴² Nor does it give him any security interest in the goods unless the dealer re-acquires ownership thereof, as previously discussed.⁴³

In my opinion, this practical point, should be recognized even though by definition any sale of chattel paper or accounts, even without recourse, is a security interest transaction involving a debtor and a secured party, the dealer being the debtor, the secured party being SP2 and the subject matter of the sale being the collateral.⁴⁴ This set of definitions is merely a statutory device to bring sales of receivables into Article 9. This formal situation should not conceal the fact that in a sale transaction neither the dealer nor SP1 has any continuing interest in the chattel paper or in the goods unless and until there is a default by BIOC and the goods come back to the dealer, under conditions explored above.

On the other hand, if the advance is less than complete, then the dealer has a continuing residual interest in the chattel paper and, through it, the goods. Whether that interest is sufficient to give SP1 a continuing inventory interest in the collateral depends on the form of contract, although I doubt that the typical inventory financing contract would cover it.

Nevertheless, I agree with Professor Barnes’ view that when there is a meaningful residual interest of the dealer in the chattel paper, the proper resolution of the problems dealt with by section 9-306(5) is different from the problem when there has been a sale which terminates the dealer’s interest and that of SP1. I am not attempting to explore in this paper what the overall resolution of these sets of facts should be where there is a residual interest.

Professor Barnes’ assertion, that in a with-recourse sale the dealer (and through him SP1) should be deemed to retain a residual interest in the goods, is faulty from a business point of view as well as legally. Professor Barnes’ position is based on an assumption, without any underlying discussion, that SP2 does not rely on the collat-

42. See *supra* text accompanying note 34.

43. See *supra*, point 4, at 12-13.

44. U.C.C. §§ 1-201(37), 9-102(1)(b), 9-105(1)(c), (d), (m) (1985).

eral, to any significant extent, when he has recourse against the dealer, and that he does not need any such reliance on the collateral.⁴⁵ There is no factual basis for this assumption, and any person experienced in asset-based financing could have told him so. Any automobile dealer, for instance, may have received inventory financed by SP1 to the extent of 100 percent of cost. The inventory may well equal or exceed his net worth. He may turn his inventory over several times a year. (A sixty-day supply is thought of as standard in the automobile dealership business.) On each turnover he creates chattel paper. The chattel paper may last three to five years. Thus, there will be an enormous amount of chattel paper outstanding relative to the dealer's net worth. Sale of the chattel paper to SP2 with recourse preserves this discrepancy between net worth and liability. Substantial reliance on that net worth by SP2 cannot begin to be adequate, and SP2 relies for the safety of his portfolio on the debtors' (BIOC's) ability to pay and on resort to the collateral when necessary. Since the dealer has little net worth compared to his obligations, the recourse may be taken more as a disciplinary measure than otherwise, to ensure that dealers put the transactions together responsibly, knowing that they may not escape scot-free if they sell weak transactions to finance companies or banks. Frequently, a dealer subject to recourse cannot pay until he resells the car, thus creating some of the problems discussed above as to when the statute gives SP1 rights based on the dealer's right. In my view, it would be a great mistake to draw any distinction in the treatment of these problems between recourse and nonrecourse sale transactions, although I have recognized that if the dealer has a significant residual interest in the paper there may be different problems which I do not explore in this article.

8. While I am discussing my disagreement with Professor Barnes' approach, I will take up another point where I disagree with his reasoning but agree with his policy approach in principle, but not under the present statute. The question is whether SP2, who asserts a security interest in repossessed inventory, and is given a priority over SP1 by clause (b) of section 9-306(5), must give notice to SP1 as a "creditor" of the dealer under clause (d). An additional question is whether SP2 should give notice to SP1 in a manner similar to the notice required from a purchase-money secured party claiming priority in inventory under section 9-312(3).

45. Barnes, *supra* note 27, at 400-05.

The Barnes article finds a clash between Article 9's usual requirement of notice in split ownership situations and an alleged concept of the negotiability or quasi-negotiability of assets underlying chattel paper in section 9-306(5).⁴⁶ Professor Barnes thinks that a concept of quasi-negotiability of the assets underlies the subsection, and amazingly he claims that this represents a victory for me. He cites an early article of mine.⁴⁷ If I understand him, he thinks that the section makes a fundamental mistake by extending the concept of quasi-negotiability of chattel paper in order to give quasi-negotiability also to the assets securing the chattel paper. If he thinks that that was my intention, he is completely mistaken, as a perusal of my cited article will show; I am sure that he is also mistaken as to the intent of the draftsmen of section 9-306(5), obscure as that intent is.

Professor Barnes is also wrong in asserting that the present subsection's treatment of priorities as to chattel paper and Article 3's treatment of it represents a victory for me. Indeed, as indicated above, I had nothing to do with the subsection until, during the drafting of the 1972 amendments to Article 9, I raised some questions the answers to which the Review Committee did not care to pursue. In my 1950 article I did urge that the obligation aspect of chattel paper not be ignored in favor of its security interest aspect when it came to any disciplinary remedies for consumer abuses. Professor Barnes thinks that I had to argue for the transferability of chattel paper by delivery. On the contrary, I believed that it had always been transferable by delivery, not assignment, as a "specialty," but I recognized that there was doubt. I argued for permission under the Code to perfect a transfer by filing as an alternative to delivery, a point which led to the first sentence of section 9-304(1) and to section 9-308(a). But Professor Barnes uses the point to somehow disapprove the failure of the present subsection to require any notice to an original secured party (SP1) that SP2 claims in the returned or repossessed goods a security interest to which clause (b) of the subsection gives priority as against the inventory security interest. Whether the subsection does omit any requirement of notice

46. *Id.* at 393-94, 406-07.

47. Kripke, *Chattel Paper as a Negotiable Specialty under the Uniform Commercial Code*, 59 YALE L.J. 1209 (1950). Note that the date is before any definitive draft of Article 9 had been produced. My view was that the courts' arguments for holding chattel paper not to be negotiable or the holders not to be holders in due course were technically incorrect, but that the point was immaterial to a buyer of chattel paper who dealt only with respectable and credit-worthy dealers. The cases of which I expressed disapproval did not rest on the concept of the adhesion contract. Since the consumer buyer does not understand what he is contracting, when he "adheres" to negotiable paper or to contracts with waiver-of-defense clauses, I have no objection to the Code's recognition in § 9-206 of protective rules on that subject for consumer buyers in well-drawn legislation, but it can be done without breaching well-understood rules as to negotiability. My article had nothing to do with "negotiability of assets."

to SP2 is a matter of some dispute in the cases. The Permanent Editorial Board for the Uniform Commercial Code has published a Commentary,⁴⁸ in which I fully concurred, as an interpretation of the present statute, to the effect that the requirement of notice to creditors in clause (d) does not require notice to SP1 in order to preserve SP2's priority under clause (b). Professors Skilton and Dunham also agree with this position.⁴⁹ Such a further requirement would be totally inconsistent with the intent of section 9-306(b).

In any event, the problem has probably become a dead letter since the issue became known to professionals engaged in asset-based financing of this type, because many of them adopted the practice of filing immediately to cover repossessed or returned goods when they begin the relationship.⁵⁰ Such a filing would bring the matter of priority under section 9-312, not section 9-306(5).

But when the issue is what a newly revised future statute should provide in this respect, I agree with Professor Barnes' result, while rejecting his reasoning. I will articulate my very different reasoning: a general inventory financier of automobiles or of most goods will frequently be handling inventory financing of trade-ins of the same brands as new goods. On new goods he may be advancing funds to the dealer to pay the shipper as soon as he is advised of a shipment, without checking public files for financing statements of financiers who may have purchase-money priority over him. For that reason, where his assumed priority based on a first filing could be lost by the priority accorded to purchase-money inventory financing, section 9-312(3) requires that he be alerted not only by a prompt filing by the purchase-money financier, but also by specific notification in writing to SP1 that the other party is going to conduct purchase-money financing on inventory described by item or type. One might quibble that this statute is still inadequate, because SP1 would not know which items of a type were covered by the purchase-money financing; but this is not a serious point, because the purchase-money financier will probably be financing all new items of specified types.

In contrast, in the type of prior claim asserted by SP2 in a case under present section 9-306(5)(b) following a return or repossession, even an early filing may not give him a purchase-money priority. It

48. This Proposed Commentary to the Uniform Commercial Code is published in Current Materials Highlight, Part II, 8 U.C.C. Rep. Serv. 2d (Callaghan) (June 1989).

49. Skilton, *supra* note 23, at 835.

50. See *supra* note 38 and accompanying text.

is the Code section, 9-306(5)(b), which gives him priority, and there is not any provision for express notice to SP1. Even an express notice covering repossessed used goods by type would leave SP1 without an informative notice which would permit him to distinguish between used goods taken in trade and those of the same type repossessed and claimed by SP2. Thus, the problem of being fair in terms of notice to SP1, if he is going to find his floating inventory security interests subordinated, is more difficult than in the section 9-312(3) situation. It is conceivable that specific notice of claims to individual repossessions may be the only fair solution. Fortunately, repossessions are not so frequent as to impose an unreasonable burden on SP2.

9. The case of accounts has some problems going beyond the case of chattel paper. By assumption, the accounts are unsecured. Therefore, goods which were the subject matter of an account after default cannot be repossessed.⁵¹ Thus, after a completed sale SP1 had no interest in the goods or the accounts, and SP2 had no interest in the goods, while it had an interest in the accounts.⁵² Again, the question arises whether the dealer could accept a return when the account was owned by SP2, without the acquiescence of SP2 in the absence of facts permitting revocation of acceptance by the debtor under Article 2. When SP2 delivers the goods or acquiesces in the dealer's acceptance of the goods from BIOC, SP2 can negotiate any security interest in the goods that he chooses. Why is it necessary for the statute to give him a security interest? Moreover, what justification is there for the statute to confer a "superior" interest on SP1?

CONCLUSION

These considerations show, in my view, that the present section 9-306(5) is a mess. The fact that we have lived with it for so long shows that it is not a vital part of Article 9, and it will not be feasible to convene a drafting task force to make an effort to revise this subsection standing alone. But certainly when Article 9 is next reopened, this subsection should either be dropped entirely or extensively reconsidered — or more accurately, extensively considered for the first time — and drastically revised and rewritten.

51. We are putting aside possible equitable reclamation of the goods where it could be shown that the debtor never intended to pay or that he misrepresented his solvency at the time of the deal. Compare U.C.C. § 2-702(3) (1985); Bankruptcy Code, 11 U.S.C. 546(c) (1983).

52. See *supra* note 25.